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SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-69368; File No. SR-BOX-2013-20)

April 12, 2013

Self-Regulatory Organizations; BOX Options Exchange LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Suspend Certain Provisions in Rule 7170 Regarding Obvious Errors during Limit Up-Limit Down States in Securities that Underlie Options Traded on the Exchange on a Pilot Basis

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “Exchange Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on April 8, 2013, BOX Options Exchange LLC (the “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to amend IM-7080-1 (Trading Conditions During Limit State or Straddle State) to permit the Exchange to suspend certain provisions in BOX Rule 7170 (Obvious and Catastrophic Errors) during limit up-limit down states in securities that underlie options traded on the Exchange on a pilot basis. The text of the proposed rule change is available from the principal office of the Exchange, at the Commission’s Public Reference Room and also on the Exchange’s Internet website at <http://boxexchange.com>.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

## II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

#### 1. Purpose

The Exchange proposes to amend IM-7080-1 (Trading Conditions During Limit State or Straddle State) to permit the Exchange to suspend certain provisions in BOX Rule 7170 (Obvious and Catastrophic Errors) during limit up-limit down states in securities that underlie options traded on the Exchange on a pilot basis. This is a competitive filing that is based on a proposal recently submitted by International Securities Exchange, LLC ("ISE") and approved by the Commission.<sup>3</sup>

#### Background

On May 31, 2012, the Commission approved the Plan to Address Extraordinary Market Volatility (the "Plan"),<sup>4</sup> which establishes procedures to address extraordinary volatility in NMS Stocks. The procedures provide for market-wide limit up-limit down requirements that prevent trades in individual NMS Stocks from occurring outside of specified Price Bands. These limit up-limit down requirements are coupled with Trading Pauses to accommodate

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<sup>3</sup> See Securities Exchange Act Release No. 69329 (April 5, 2013) (SR-ISE-2013-22).

<sup>4</sup> Securities Exchange Act Release No. 67091 (May 31, 2012), 77 FR 33498 (June 6, 2012) (File No. 4-631) ("Plan Approval Order").

more fundamental price moves. The Plan procedures are designed, among other things, to protect investors and promote fair and orderly markets.<sup>5</sup>

BOX is not a participant in the Plan because it does not trade NMS Stocks. However, BOX trades options contracts overlying NMS Stocks. Because options pricing models are highly dependent on the price of the underlying security and the ability of options traders to effect hedging transactions in the underlying security, the implementation of the Plan will impact the trading of options classes traded on the Exchange. Specifically, under the Plan, upper and lower price bands will be calculated based on a reference price for each NMS Stock.<sup>6</sup> When one side of the market for an individual security is outside the applicable price band, the national best bid or national best offer will be disseminated with a flag identifying it as non-executable (i.e., a “Straddle State”). When the other side of the market reaches the applicable price band, such national best bid or offer will be disseminated with a flag identifying it as a Limit State Quotation.<sup>7</sup> If trading for a security does not exit a Limit State within 15 seconds, a Trading Pause will be declared by the Primary Listing Exchange.<sup>8</sup> The

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<sup>5</sup> Id. at 33511 (Preamble to the Plan).

<sup>6</sup> The reference price equals the arithmetic mean price of eligible reported transactions for the NMS Stock over the immediately preceding five-minute period. See Section I(T) of the Plan.

<sup>7</sup> See Section I(D) of the Plan. The Limit State will end when the entire size of all Limit State Quotations are executed or cancelled.

<sup>8</sup> See Section VII(A) of the Plan. The Primary Listing Exchange is the market on which an NMS Stock is listed. If an NMS Stock is listed on more than one market, the Primary Listing Exchange is the market on which the security has been listed the longest. See Section I(O) of the Plan. A trading pause may also be declared when the national best bid (offer) is below (above) the lower (upper) price band and the security is not in a Limit State, and trading in that security deviates from normal trading characteristics. See Section VII(A)(2) of the Plan.

Trading Pause will last at least five minutes<sup>9</sup> and will end when the Primary Listing Exchange disseminates a Reopening Price.<sup>10</sup>

### Proposal

When the national best bid (offer) for a security underlying an options class is non-executable, the ability for options market participants to purchase (sell) shares of the underlying security and the price at which they may be able to purchase (sell) shares will become uncertain, as there will be a lack of transparency regarding the availability of liquidity for the security.<sup>11</sup> This uncertainty will be factored into the options pricing models of market professionals, such as options market makers, which will likely result in wider spreads and less liquidity at the best bid and offer for the options class. Accordingly, during a Limit State, the Exchange will automatically reject all incoming orders that do not contain a limit price to protect them from being executed at prices that may be vastly inferior to the prices available immediately prior to or following a Limit State or Straddle State.<sup>12</sup> Such un-priced orders

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<sup>9</sup> A Trading Pause may last longer than 5 minutes if, for example, the Primary Market declares a Regulatory Halt, or if there is a significant order imbalance. See Section VII(B) of the Plan. If the Primary Listing Exchange does not report a Reopening Price within ten minutes after the declaration of a trading Pause and has not declared a Regulatory Halt, all trading centers may begin trading the security. Id.

<sup>10</sup> The Reopening Price is the price of a transaction that reopens trading on the Primary Listing Exchange following a Trading Pause or a Regulatory Halt, or, if the Primary Listing Exchange reopens with quotations, the midpoint of those quotations. The Exchange notes that under BOX Rule IM-7080-11 (IM-7080-12 as of 4/7), trading on the Exchange is halted whenever trading in the underlying security has been paused by the primary listing market. Accordingly, the Exchange need not adopt any rule changes to address this aspect of the Plan.

<sup>11</sup> See Letter to Boris Ilyevsky, Managing Director, ISE, from Thomas Price, Managing Director, Securities Industry and Financial Markets Association, dated October 4, 2012 (“SIFMA Letter”).

<sup>12</sup> See Securities Exchange Act Release No. 69186 (March 20, 2013), 78 FR 18413 (March 26, 2013) (SR-BOX-2013-12).

include Market Orders and BOX-Top Orders, which become market orders when the stop price is elected. The Exchange will also cancel any resting Market Orders and BOX-Top Orders.

The Exchange proposes to exclude transactions executed during a Limit State or Straddle State from certain provisions in BOX Rule 7170, on a one-year pilot basis. This will not include Rule 7170(e) and (f), which specify when a trade resulting from an erroneous print or quote in the underlying security may be adjusted or busted.

The remaining provisions in BOX Rule 7170 provide a process by which a transaction may be busted or adjusted when the execution price of a transaction deviates from the option's theoretical price by a certain amount. Under these provisions, the theoretical price is the national best bid price for the option with respect to a sell order and the national best offer for the option with respect to a buy order.<sup>13</sup> As discussed above, during a Limit State or Straddle State, options prices may deviate substantially from those available prior to or following the limit state. The Exchange believes these provisions would give rise to much uncertainty for market participants as there is no bright line definition of what the "theoretical value" should be for an option when the underlying NMS stock has an unexecutable bid or offer or both. Determining "theoretical value" in such a situation would be often times very subjective as opposed to an objective determination, giving rise to additional uncertainty and confusion for investors. Accordingly, the Exchange does not believe that the approach employed under Rule

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<sup>13</sup> Rule 7170 provides that if there are no quotes from other options exchanges for comparison purposes, the theoretical price will be determined by designated personnel in the MRC. However, given that options market makers and other industry professionals will have difficulty pricing options during Limit States and Straddle States, the Exchange does not believe it would be reasonable for BOX personnel to derive theoretical prices to be applied to transactions executed during such unusual market conditions.

7170, which by definition depends upon a reliable national best bid and offer in the option, is appropriate during a Limit State or Straddle State.<sup>14</sup>

After careful consideration, the Exchange believes the application of the current provisions in Rule 7170 would be impracticable given the lack of a reliable national best bid or offer in the options market during Limit States and Straddle States, and produce undesirable effects. Pursuant to Rule 7170, market participants have five minutes (in the case of a Market Maker) and 20 minutes (in the case of a non-Market Maker Options Participant) to notify the Exchange to review a transaction as an obvious error under 7170(g)(1) and Participants have until 8:30 a.m. the following day to request that the Exchange review a trade as a catastrophic error under Rule 7170(h)(1).<sup>15</sup> The Exchange believes that during periods of extraordinary volatility, the review period for transactions under the obvious error and catastrophic error provisions would allow market participants to re-evaluate a transaction that occurred during a Limit State or Straddle State at a later time, which is potentially unfair to other market participants and would discourage market participants from providing liquidity during Limit States or Straddle States. For example, 20 minutes after a transaction that occurs during extraordinary volatility that triggers a Limit State or Straddle State the market could look drastically different from a price and liquidity level. The Exchange believes that market participants should not be able to benefit from the time frame to review their transactions in these situations. Suspending application of certain provisions in Rule 7170 would mitigate two

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<sup>14</sup> See SIFMA Letter, supra note 11 (requesting that exchange obvious error rules that reference theoretical prices be reviewed to ensure that options exchange officials do not have the discretion to cancel executions of limit orders and stop limit orders during a limit or straddle state).

<sup>15</sup> For transactions in expiring options series that take place on expiration Friday, a Participant must notify MOC by 5:00 p.m. Eastern Time on that same day. See Rule 7170(h)(1).

of the undesirable aspects described above – (i) the moral hazard associated with granting a second look to trades that went against the market participant after market conditions have changed and (ii) gaming the obvious error rule to retroactively adjust market maker quotes by adjusting the execution price at a later time.

The Exchange notes that there are additional protections in place outside of the Obvious and Catastrophic Error Rule that will continue to safeguard customers. First, SEC Rule 15c3-5 requires that, “financial risk management controls and supervisory procedures must be reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds, or that appear to be erroneous.”<sup>16</sup> Secondly, the Exchange has price checks applicable to limit orders that reject limit orders that are priced sufficiently far through the NBBO that it seems likely an error occurred. The requirements placed upon broker dealers to adopt controls to prevent the entry of orders that appear to be erroneous, coupled with Exchange functionality that filters out orders that appear to be erroneous, serve to sharply reduce the incidence of errors arising from situations where, for example, a participant mistakenly enters an order to pay \$20 for an option offered at \$2. The Exchange also notes that pursuant to BOX Rule 7230(e), the Exchange may compensate Options Participants for losses resulting directly from the malfunction of the Exchange’s systems, and that this protection is independent from the provisions in BOX Rule 7170. Accordingly, the Exchange believes it is appropriate to eliminate any potential protection applying the obvious error rule might provide during Limit and Straddle States, as its application may produce inequitable results.

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<sup>16</sup> See Securities and Exchange Act Release No. 63241, 75 FR 69791 (November 15, 2010) (S7-03-10).

The Exchange notes that Rule 15010 (Order Protection) will continue to apply during Limit and Straddle States. Accordingly, only orders identified as Intermarket Sweep Orders will trade through protected bids and offers during Limit and Straddle States, and as a result, the only trades that would potentially have been reviewed under Rule 7170 during Limit and Straddle States are those involving Intermarket Sweep Orders. The Exchange believes that this is an additional factor that supports its proposal to suspend certain provisions in Rule 7170 during Limit and Straddle States.

The Exchange proposes to review the operation of this proposal during the one-year pilot period from the operative date and analyze the impact of the Limit and Straddle States accordingly.<sup>17</sup> In this respect, the Exchange notes that its current obvious error rule does not contain a provision that permits the Exchange to review trades on its own motion. The Exchange believes that in normal market conditions, such a provision is not necessary and undermines the objective nature of the rule. However, during the pilot period, the Exchange will evaluate whether adopting such a provision for reviewing trades during Limit and Straddle states is necessary and appropriate.

Additionally, the Exchange represents that it will conduct its own analysis concerning the elimination of the obvious error rule during Limit and Straddle States and agrees to provide the Commission with relevant data to assess the impact of this proposed rule change. As part of its analysis, the Exchange will evaluate (1) the options market quality during Limit and Straddle States, (2) assess the character of incoming order flow and transactions during Limit and Straddle States, and (3) review any complaints from members and their customers concerning executions during Limit and Straddle States. The Exchange also agrees to

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<sup>17</sup> During the pilot, the Exchange will provide the Commission with data regarding the how Limit and Straddle States affect the quality of the options market.



provide to the Commission data requested to evaluate the impact of the elimination of the obvious error rule, including data relevant to assessing the various analyses noted above.

The Exchange notes that these proposed changes are consistent with the views of the Securities Industry and Financial Markets Association's ("SIFMA") Listed Options Trading Committee.<sup>18</sup>

Specifically, the Exchange agrees to provide the following data to the Commission to help evaluate the impact of the proposal. At least two months prior to the end of the pilot period the Exchange shall provide an assessment that evaluates the statistical and economic impact of Straddle States on liquidity and market quality in the options markets; and assess whether the lack of obvious error rules in effect during the Straddle and Limit States is problematic. On a monthly basis, the Exchange shall provide both the Commission and public a dataset containing the data for each Straddle and Limit State in optionable stocks.<sup>19</sup>

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<sup>18</sup> Id.

<sup>19</sup> The dataset will include the options for each underlying security that reaches a straddle state and meets the following conditions: the option is more than 20% in the money (strike price remains < 80% of last stock trade price for calls and strike price remains > 120% of last stock trade price for puts when the straddle or limit state is reached); the option has at least 2 trades during the straddle or limit state; and any of the top 10 options (as ranked by overall contract volume on that day) that meet the conditions above. For each of those options affected the data record will contain the stock symbol, option symbol, time at the start of the straddle or limit state, an indicator for whether it is a straddle or limit state. For activity on the Exchange the data record will contain the executed volume, time-weighted quoted bid-ask spread, time-weighted average quoted depth at the bid, time-weighted average quoted depth at the offer, high execution price, low execution price, number of trades for which a request for review for error was received during straddle or limit states, an indicator variable for whether those options outlined above have a price change exceeding 30% during the underlying stock's straddle or limit state compared to the last available option price as reported by OPRA before the start of the straddle or limit state (1 if observe 30% and 0 otherwise), and another indicator variable for whether the option price within five minutes of the underlying stock leaving straddle or limit state (or halt if applicable) is 30% away from the price before the start of the straddle or limit state.

## 2. Statutory Basis

The Exchange believes that the proposal is consistent with the requirements of Section 6(b) of the Securities Exchange Act of 1934 (the “Act”),<sup>20</sup> in general, and Section 6(b)(4) of the Act,<sup>21</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general to protect investors and the public interest.

The Exchange believes that it is necessary and appropriate in the interest of promoting fair and orderly markets to exclude transactions executed during a Limit State or Straddle State from the provision of BOX Rule 7170. The Exchange believes the application of the current rule will be impracticable given the lack of a reliable national best bid or offer in the options market during Limit States and Straddle States, and that the resulting actions (i.e., busted trades or adjusted prices) may not be appropriate given market conditions. This change would ensure that limit orders that are filled during a Limit State or Straddle State would have certainty of execution in a manner that promotes just and equitable principles of trade, removes impediments to, and perfects the mechanism of a free and open market and a national market system. Moreover, given that options prices during brief Limit States or Straddle States may deviate substantially from those available shortly following the Limit State or Straddle State, the Exchange believes giving market participants five minutes (in the case of a Market Maker) and 20 minutes (in the case of a non-Market Maker Options Participant) to re-evaluate a transaction would create an unreasonable adverse selection opportunity that would discourage participants

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<sup>20</sup> 15 U.S.C. 78f(b).

<sup>21</sup> 15 U.S.C. 78f(b)(4).

from providing liquidity during Limit States or Straddle States. In this respect, the Exchange notes that by rejecting market orders and cancelling pending market orders, only those orders with a limit price will be executed during a Limit State or Straddle State. Therefore, on balance, the Exchange believes that removing the potential inequity of busting or adjusting executions occurring during Limit States or Straddle States outweighs any potential benefits from applying Rule 7170 during such unusual market conditions. Additionally, as discussed above, there are additional pre-trade protections in place outside of the Obvious and Catastrophic Error Rule that will continue to safeguard customers.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. In this regard and as indicated above, the Exchange notes that the rule change is being proposed as a competitive response to a filing submitted by ISE that was recently approved by the Commission.<sup>22</sup> The Exchange does not believe that the proposal will have any impact on competition among exchanges or market participants on the Exchange, as the proposal provides that transactions executed during such states will not be reviewed pursuant to provisions in Rule 7170.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The Exchange has neither solicited nor received comments on the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the foregoing proposed rule change does not significantly affect the protection of investors or the public interest, does not impose any significant burden on competition, and, by

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<sup>22</sup> See supra note 3.

its terms, does not become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A) of the Act<sup>23</sup> and Rule 19b-4(f)(6) thereunder.<sup>24</sup>

The Exchange has requested that the Commission waive the 30-day operative delay. The Commission believes that waiver of the operative delay is consistent with the protection of investors and the public interest because the proposal is substantially similar to those of other exchanges that have been approved by the Commission to exclude transactions executed during a Limit State or Straddle State from certain provisions of the obvious error rules.<sup>25</sup> Further, the Commission notes that the Plan, to which these rules relate, was implemented on April 8, 2013. Therefore, the Commission designates the proposal operative upon filing.<sup>26</sup>

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

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<sup>23</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>24</sup> 17 CFR 240.19b-4(f)(6). In addition, Rule 19b-4(f)(6)(iii) requires the Exchange to give the Commission written notice of the Exchange's intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. The Exchange has satisfied this requirement.

<sup>25</sup> See, e.g., supra note 3.

<sup>26</sup> For purposes only of waiving the 30-day operative delay, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-BOX-2013-20 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-BOX-2013-20. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should

submit only information that you wish to make available publicly. All submissions should refer to File Number SR-BOX-2013-20 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>27</sup>

Elizabeth M. Murphy  
Secretary

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<sup>27</sup> 17 CFR 200.30-3(a)(12).